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Chairman Maybank and Members of the South Carolina Tax Realignment Commission (TRAC), thank you for inviting me to provide COST's views on South Carolina's tax system. My testimony covers three related issues: 1) the current state and local tax burden on South Carolina's businesses; 2) the impact on jobs and investment in South Carolina of policy options that have been suggested for South Carolina or that are being considered in other states, including combined reporting, expansion of the sales tax base and alternative base (gross receipts) taxes; and 3) suggestions to improve tax administration that will benefit South Carolina taxpayers regardless of the type or level of taxes imposed by the state.

About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of nearly 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Measuring the State Business Tax Burden

Ernst & Young, in conjunction with COST, annually estimates the total state and local tax burden imposed on businesses in each state. Our seventh annual report was released in March, 2010.[1]

[1] Phillips, Andrew, Robert Cline and Tom Neubig, *"Total State and Local Business Taxes: 50-State-by-State Estimates for Fiscal Year 2009,"* March 2010, http://www.cost.org/WorkArea/DownloadAsset.aspx?id=76116.

This "State Tax Burden" study provides estimates of the taxes paid by businesses in each state, which is an important first step in any evaluation of business taxes or tax reform. The study estimates business property taxes, sales and excise taxes paid by businesses on their input purchases, gross receipts taxes, corporate income and franchise taxes, business and corporate license taxes, unemployment insurance taxes, individual income taxes paid by owners of non-corporate (pass-through) businesses and other state and local taxes that are the statutory liability of business taxpayers. To enable comparisons across states, the study expresses business taxes as a share of total state and local taxes and as an effective tax rate on private sector economic activity (taxes as a share of gross state product).

In FY 2009, South Carolina businesses paid $6 billion in state and local taxes. This figure translates to a total effective business tax rate (TEBTR) imposed on business activity in South Carolina of 4.7%. The TEBTR is measured as the ratio of state and local business taxes to private-sector gross state product (GSP), the total value of a state's annual production of goods and services by the private sector. The average TEBTR across all states is also 4.7%.

Although South Carolina's TEBTR of 4.7% is equal to the national average, it is quite high when compared with other states in the Southeast. For example, South Carolina's TEBTR is higher than Georgia's (4.1%), North Carolina's (3.5%), Virginia's, (3.6%) and Alabama's (4.6%), but lower than Florida's (5.3%).

TEBTRs provide a useful starting point for comparing burdens across states, but they do not provide sufficient information to fully evaluate a state's competitiveness. A state with an average overall TEBTR may impose relatively high taxes on capital intensive manufacturers, while imposing relatively low taxes on labor-intensive service industries. As a result, a state with such a tax structure and composition may create disincentives for locating new plant and equipment in the state and hinder economic growth—such as imposing tangible personal property taxes on business equipment. State legislators and policy-makers need to look closely at the structure and composition of business taxes and the composition of economic activities when evaluating their state's business tax competitiveness. A new study being prepared by Ernst & Young, again in conjunction with COST, will focus on the issue of business tax competitiveness.

What is the Rationale for Business Taxation?

Increasing economic competition among states and countries around the globe has transformed the initial question into a more fundamental query: "What is the basis or rationale for business taxation at the state or local level?" The basic rationale for business taxes, recognizing that the economic burden of business taxes are ultimately borne by consumers or owners of factors of production (including workers), is to pay for government services that directly benefit businesses.

If state and local business taxes were equal to the value of the benefits business received from state and local public services, they could be considered a payment for services, and taxes would not influence business location decisions or impact competitiveness. However, if state and

local business taxes exceed the value of the benefits received from government services, the difference represents an excess cost to business that will reduce profitability in the absence of shifting the tax through higher prices or lower payments to labor. When such excess costs exist, they can affect a company's choice of locations.

In FY 2007 (the latest year for which both tax and expenditure data is available), the COST/E&Y study estimates that South Carolina businesses paid $5.9 billion in state and local taxes while benefitting from only $3.8 billion in state and local expenditures (mid-point estimate). In other words, the state and local tax burden on South Carolina businesses is roughly 55% higher than justified by the services government provides to businesses. The economic impact of these excess taxes falls on consumers through higher prices, workers through lower pay or reduced employment, or shareholders through reduced profits.

State Corporate Income Taxes & Mandatory Unitary Combined Reporting

State corporate income taxes seem to garner an inordinate amount of attention from policymakers, commentators, and interest groups – perhaps because the tax is often perceived by the uninformed to be the primary source of business taxation levied by states. In fact, state corporate income taxes contribute relatively small amounts to state coffers. Nationally, in FY 2009, state corporate income taxes generated only 8.6% of total state and local business taxes. In South Carolina, it comprises approximately 4% of all business taxes. Yet because the tax is inherently unstable (it only operates when a corporation earns income), and because the myriad of bases, rates and rules among states allow tax planning opportunities, it is widely vilified as rife with "loopholes" that need "closing." State corporate income taxes are also tremendously complex, creating costs of compliance and tax administration that are far out of proportion to other significant taxes paid by businesses, such as property or sales taxes.

Indeed, many public finance economists "find little justification for the state corporate income tax" in the first instance.[2] Professor Charles McLure says:

> It is hard to think of a good reason to tax corporate income….The case against state corporate income taxes is even stronger. It is common among economists to acknowledge that a small open economy (one that cannot affect the world price of capital) should not tax the return required to elicit investment within its boundaries….The difficulty of actually taxing corporate income where it originates is a further reason for not trying to tax it.[3]

Despite the economic consensus that the state corporate income tax is a poor tax, it exists. And, because of the erroneous public perception that the corporate income tax is the primary

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[2] Fox, William F., Matthew N. Murray and LeAnn Luna, "*How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?"* National Tax Journal, March 2005.

[3] McLure, Charles, "*How to Improve California's Tax System: The Good (But Infeasible), the Bad, and the Ugly,"* California Commission on the 21st Century Economy, February 2009 (http://www.cotce.ca.gov/meetings/testimony/documents/1-CHARLES%20McLURE%20-%20COTCE%20paper.pdf).

business tax, one of the most controversial business tax policy issues currently debated by state legislators, tax administrators, and corporate taxpayers is how a state should determine the corporate income tax base for multistate corporations with multiple businesses and entities. One method—mandatory unitary combined reporting (MUCR)—is touted by proponents as a "loophole closer" and as a way to stop "income shifting" to low tax jurisdictions. In actuality, however, mandatory unitary combined reporting carries severe economic consequences: it arbitrarily assigns income to a state, negatively impacts the real economy, and imposes significant administrative burdens on both the taxpayer and state.[4]

- Arbitrarily Assigns Income – Although proponents of MUCR argue that it helps to overcome distortions in the reporting of income among related companies in separate filing systems, the mechanics used under MUCR create new distortions in assigning income to different states. The MUCR assumption that all corporations in an affiliated unitary group have the same level of profitability is not consistent with either economic theory or business experience. Consequently, MUCR may reduce the link between income tax liabilities and where income is actually earned. Many corporate taxpayers may conclude that there is a significant risk that MUCR will arbitrarily attribute more income to a state than is justified by the level of a corporation's real economic activity in the state.

- Negatively Impacts the Real Economy – Proponents of MUCR have focused on the benefits in terms of reducing tax planning opportunities, but they fail to acknowledge that MUCR may result in higher effective corporate income tax rates. Economic theory suggests that these higher effective tax rates will ultimately be borne by labor in the state through fewer jobs (or lower wages over time) or by in-state consumers through higher prices for goods and services.

- Significant Administrative Burden

    - *Determining the Unitary Group:* The concept of a "unitary business" is uniquely factual and universally poorly-defined. It is a constitutional (Due Process) concept that looks at the business as a whole rather than individual separate entities or separate geographic locations. In order to evaluate the taxpayer's determination of a unitary relationship, state auditors must look beyond accounting and tax return information. Auditors must annually determine how a taxpayer and its affiliates operate at a fairly detailed level to determine which affiliates are unitary. Auditors must interact with a corporation's operational and tax staff to gather this operational information. In practice, however, auditors routinely refuse to make a determination regarding a unitary relationship on operational information and instead wait to determine unitary relationships until after they have performed tax computations. In other words, the tax result of the finding that a unitary relationship exists (or does not

[4] A thorough discussion of the problems associated with MUCR can be found in the study prepared for COST by Ernst & Young LLP, *"Understanding the Revenue and Competitive Effects of Mandatory Unitary Combined Reporting"* (http://www.cost.org/WorkArea/DownloadAsset.aspx?id=70000).

exist) often significantly influences, or in fact controls the auditor's finding. Determining the scope of the unitary group is a complicated, subjective, and costly process that is not required in separate filing states and often results in expensive, time-consuming litigation.

- *Calculating Combined Income* – Calculating combined income is considerably more complicated than simply basing the calculations on consolidated federal taxable income. In most MUCR states, the group of corporations included in a federal consolidated return differs from the members of the unitary group. In addition to variations in apportionment formulas among the states that apply to all corporate taxpayers, further compliance costs related to MUCR result from variations across states in the methods used to calculate the apportionment factors.

Mandating unitary combined reporting exacerbates the problems with the corporate income tax. In light of the underlying conceptual flaws in the state corporate income tax, the TRAC should support either elimination of the corporate income tax or adoption of a New Mexico-style election that allows corporations to choose to file on a separate, combined or consolidated basis.

"Alternative Base" Business Taxes

In part because of the flaws associated with the corporate income tax, a handful of states have considered or enacted new business taxes that are based on some alternative base. These alternative base taxes are generally derived from—or linked to—gross receipts. Gross receipts taxes are widely acknowledged to violate numerous tax policy principles. The remainder of this section is excerpted from a paper titled "Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance" (January 2007). This paper was prepared for COST and the Tax Foundation by John Mikesell, professor of public finance and policy analysis and director of the Master of Public Affairs program at the Indiana University School of Public and Environmental Affairs. The paper can be viewed in its entirety at: http://www.cost.org/WorkArea/DownloadAsset.aspx?id=67458.

Gross receipts taxes had largely disappeared as an important revenue source for state governments by the later years of the twentieth century, usually after considerable effort by state business groups to eliminate them. Analysts and scholars presumed that these taxes—also known as "turnover taxes"—had forever been replaced with options that made more sense as ways of distributing the cost of government and had less undesirable impact on the taxpaying public, including businesses, and generally lost interest in them. In recent years, however, such broad-base, low-rate taxes have again entered state tax policy discussions. With this re-emergence comes a need for a new analysis of gross receipts taxes to aid policymakers who are unfamiliar with their structure and drawbacks.

This examination of American and European experience with gross receipts taxation has identified several significant conclusions about the tax. These may be summarized:

- Broad Base – The gross receipts tax base can be broad, broader than the total value of production of the economy, but it lacks any link either to capacity to bear the cost of government services or to the amount of government services used—the normal standards for assigning tax burdens.

- Low rate -- Whether a gross receipts tax has a low rate depends on how much revenue the government intends to raise from it. Unlike most taxes, the effective rate of a gross receipts tax is higher than the statutory (or advertised) rate. A broad-based, low-rate gross receipts tax is unlikely to contribute a major share of tax revenue to a modern state government.

- Stable revenue – A gross receipts tax appears to be roughly as stable as a retail sales tax. Its variations do not contribute to the overall stability of total state revenue because its fluctuations follow generally the same pattern as other major taxes.

- Economic neutrality – A gross receipts tax interferes with private market decisions. Its pyramiding creates a haphazard pattern of incentives and disincentives for business operations. Most significantly, it establishes artificial incentive for vertical integration and discriminates against contracting work with independent suppliers and the advantages of scale and specialization that production by independent firms can bring.

- Competitiveness – A gross receipts tax interferes with the capacity of individuals and businesses to compete with those in other states and other parts of the world. The tax embedded in prices grows as the share of a production chain within the state increases, so there is incentive to purchase business inputs from outside the state. It discourages capital investment by adding to the cost of factories, machinery, and equipment, and the disincentive increases as more of those capital goods are produced in the taxing state. This tax structure does not promote the growth and development of the state.

- Fairness – A gross receipts tax does not treat equally situated businesses the same. Firms with the same net income will face radically different effective tax rates on that income, depending on their profit margins. Low-margin firms will be at great disadvantage relative to higher-margin firms, regardless of their overall profitability. Many new and expanding firms have low margins (or even are initially unprofitable) and the gross receipts tax reduces the chance that these firms will survive. This also is not consistent with a climate for growth and development.

- Transparency – A gross receipts tax is a stealth tax with its true burden hidden from taxpayers. Hiding the cost of government is inconsistent with efficient and responsive provision of government services and contrary to the fundamentals of democratic government.

There is no sensible case for gross receipts taxation. The old turnover taxes—typically adopted as desperation measures in fiscal crisis—were replaced with taxes that created fewer economic problems. They do not belong in any program of tax reform.

Sales Taxes on Business Inputs

Sales tax imposed on business inputs in South Carolina generated $900 million in tax revenue in FY 2009.[5] Approximately 32.8% of all sales tax revenue in South Carolina comes from impositions on business inputs.[6]

Imposing sales taxes on business inputs violates several tax policy principles and causes significant economic distortions. Taxing business inputs raises production costs and places businesses within a state at a competitive disadvantage to businesses not burdened by such taxes. Taxes on business inputs, including taxes on services purchased by businesses, must be avoided.

Like the gross receipts tax, sales tax on business inputs violates several tax policy principles—economic growth, equity, simplicity and efficiency—and causes a number of economic distortions. Notably, these distortions result from pyramiding, where a tax is imposed at multiple levels, such that the effective tax rate exceeds the retail sales tax rate. Companies are forced to either pass these increased costs on to consumers or reduce their economic activity in the state in order to remain competitive with other producers who do not bear the burden of such taxes.

All states that impose sales tax currently tax business inputs to some extent, but few states tax services principally purchased by businesses. Proposals to eliminate existing sales tax exemptions for business inputs or to extend the sales tax to services purchased primarily by businesses further exacerbate the adverse economic distortions from the current taxation of business purchases. For example:

- Taxing business inputs encourages companies to self-provide business services to avoid the tax rather than purchasing them from more efficient providers and paying tax. Thus it inordinately impacts small businesses, which lack the resources to provide such services in-house;

- Taxing business inputs places companies selling in international, national and regional markets at a competitive disadvantage to many of their competitors, leading to a reduction in investment and employment in the state;

- Taxing business inputs unfairly and inefficiently taxes some products and services more than others by imposing varying degrees of tax on inputs in addition to a general tax rate on final sales; and

- Taxing business inputs unfairly hides the true cost of government services by embedding a portion of the sales tax in the final price of goods and services.

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[5] Phillips et al. This figure includes sales taxes paid on business purchases of operating inputs and capital equipment; it does not include taxes collected on sales to final consumers.

[6] Cline, Robert, John Mikesell, Tom Neubig and Andrew Phillips, *"Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services,"* January 2005 (http://www.cost.org/WorkArea/DownloadAsset.aspx?id=69068).

Efforts to extend the sales tax to services purchased primarily by business also suffer from the significant administrative complexities associated with determining where such services are "used" or consumed. This determination is much more complicated for services purchased primarily by business than it is for tangible goods.[7]

Numerous attempts to extend the sales tax to services purchased primarily by businesses have failed, including broad efforts by Florida and Massachusetts and narrower, more recent efforts in Michigan and Maryland. Not only have these efforts been hindered by the administrative complexity of such taxes but also by the recognition that such taxes are fundamentally flawed and increase the cost of doing business in a state.

When considering any changes to South Carolina's existing sales tax base, the TRAC would do well to understand the economic burdens associated with taxing business inputs, including the relatively high level of such taxes already imposed by the state.

Fair, Efficient and Customer-Focused Tax Administration:

Regardless of the types of taxes utilized in any state's revenue system, taxpayers deserve fair, efficient and customer-focused tax administration. In COST's most recent survey of state tax administration systems, South Carolina scored a respectable B grade.[8] However, the Commission should consider the following changes to improve the laws governing tax administration in South Carolina:

- Require ALJs hearing tax disputes at the ALJ Division to have tax expertise prior to appointment;
- Eliminate the requirement forcing taxpayers to pay a disputed tax prior to appeal to Circuit Court and Court of Appeals;
- Equalize the rate of interest applicable to refunds and assessments (currently 2% disparity);
- Extend the state income tax due date to 30 days beyond the federal return due date; and
- Define "final determination" for purposes of reporting federal tax changes to South Carolina.

Foremost in good tax administration is a fair and efficient tax appeals system. A state's ability to recognize the potential for error or bias in its tax department determinations and to provide taxpayers access to an independent appeals tribunal is the most important indicator of the state's treatment of its tax customers, and COST commends South Carolina for the independence of the ALJ Division. States with fair and efficient tax appeal systems, however, share two

[7] *Ibid*.
[8] Lindholm, Douglas L. and Fredrick J. Nicely, *"The Best and Worst of State Tax Administration: COST Scorecard on Tax Appeals and Procedural Requirements,"* February 2010, http://www.cost.org/WorkArea/DownloadAsset.aspx?id=75910.

additional elements: 1) the tribunal's judges should be specifically trained in tax law; and 2) taxpayers should not be required to prepay a disputed tax or post a bond before final resolution of the issue.

Trained Judges: An independent tax tribunal's judges must be specifically trained as tax attorneys, and the tribunal should be dedicated solely to deciding tax issues. The tribunal should be structured to accommodate a range of disputes from less complex tax issues, such as those arising from personal income tax matters, to highly complex corporate tax disputes. The tremendous growth and complexity in the body of tax law and the nature of our multi-jurisdictional economy makes this consideration paramount. Judges not trained in tax law are less able to decide complex corporate tax cases on their merit, and a perception exists (rightly or wrongly) that the *revenue impact* of these complex cases too often helps guide decision-makers through the fog of complicated tax statutes, regulations, and precedent. That perception reflects poorly on a state's business climate and reputation as a fair and competitive place to do business.

No Prepayment Required: At a minimum, taxpayers should not be required to post bond or pay a disputed tax before an initial hearing. More than 60% of the states grant taxpayers at least a *de novo* hearing on the validity of the assessment, in front of an independent arbiter, before payment of the tax is required. It is inherently inequitable to force a corporate taxpayer to pay a tax assessment, often based on the untested assertions of a single auditor or audit team, without the benefit of a hearing before an independent body. Free access to an independent hearing without having one's property confiscated by the law is especially important during difficult state economic climates; once tax money is paid into the system, it is often difficult or impossible to wrest a refund from the state, even after disputes are resolved in the taxpayer's favor. Ideally, taxpayers should be able to contest an assessment through final resolution of an issue without prepayment of a disputed tax.

Equalized Interest Rates: Interest rates should apply equally to both assessments and refund claims. Failure to equalize interest rates diminishes the value of the taxpayer's remedy of recovering tax monies to which it is legally entitled. Interest rates are meant to compensate for the lost time-value of money and should apply equally to both parties. The date from which interest begins to run may also be important. Because states levy interest from the due date of the return, taxpayers should receive interest from the date of the overpayment of the tax on an original return, although no interest is acceptable if paid within a reasonable time period, say 60 days, to allow state processing of the payment. For separate refund claims, interest should be paid from the date of overpayment of the tax – typically the due date of the original return – and not the date of the filing of the refund claim. Refunds and liabilities for the same taxpayer should also offset each other in calculating the amount of interest and penalty due.

Return Due Date and Automatic Extensions: The state's corporate income tax return due date should be at least 30 days after the federal tax return due date, or the state's extended due date should be at least 30 days after the federal extended due date. Further, the state's corporate income tax return due date should be automatically extended simply by obtaining a federal extension. By extending state due dates to this point, state tax administrators allow taxpayers to file correct returns based on complete federal return information. Although

corporate taxpayers often file a single consolidated federal return, the adjustments necessary to generate the multitude of state tax returns are complex and time-consuming. A minimum of 30 days beyond the extended federal due date is needed to complete these adjustments. To ease administrative burdens, an automatic state extension should only require attaching a copy of the extended federal return with the state return to qualify.

Final Determination: All states imposing a corporate income tax require a taxpayer to report changes in federal taxable income to the state. In the majority of states the requirement is triggered by when a "final determination" is made regarding the federal income tax return (*e.g.*, issuance of a Revenue Agent's Report). However, some states have no such definition. Although the Multistate Tax Commission promulgated a model uniform statute for reporting federal tax adjustments in August, 2003, the states are not using a uniform definition as to when a federal tax change constitutes a "final determination" to be reported to the state. This is unfortunate because it unnecessarily creates compliance problems and wrongfully subjects taxpayers to concomitant penalties and interest for unintentional noncompliance. COST suggests the following "best practice" as a workable definition, primarily based on the statutory definition of "final determination" used by New Hampshire. "A 'final determination' is deemed to occur when the latest of any of the following activities occurs with respect to a federal taxable year: (1) The taxpayer has made a payment of any additional income tax liability resulting from a federal audit, the taxpayer has not filed a petition for redetermination or claim for refund for the portions of the audit for which payment was made and the time in which to file such petition or claim has lapsed. (2) The taxpayer has received a refund from the U.S. Treasury that resulted from a federal audit. (3) The taxpayer has signed a federal Form 870-AD or other IRS form consenting to the deficiency or consenting to any over-assessment. (4) The taxpayer's time for filing a petition for redetermination with the U.S. Tax Court has expired. (5) The taxpayer and the IRS enter into a closing agreement. (6) A decision from the U.S. Tax Court, district court, court of appeals, Court of Claims, or Supreme Court becomes final."

Conclusion

South Carolina, like nearly every state, is grappling with severe fiscal problems. Those problems result from the significant downturn in the real economy that began in 2008. Most economic indicators suggest that the economy is beginning to improve; the State must ensure that any tax policies it adopts to address fiscal problems do not hinder the economic recovery. In reviewing the existing tax system, the TRAC should seek opportunities to minimize obstacles to investment and job creation. Proposals that would further exacerbate the State's current excess business taxation, including suggestions to implement mandatory unitary combined reporting or to impose sales tax on services purchased primarily by businesses, should be avoided. Finally, regardless of the recommendations the TRAC makes with respect to the State's tax structure, the Commission should recommend changes that will make the State's tax administrative system fairer, more efficient and customer-focused.

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